

Report
of the
Examination of
Northwestern National Casualty Company
Brookfield, Wisconsin
As of December 31, 2000

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State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

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January 9, 2002

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Honorable Connie L. O'Connell
Commissioner of Insurance
State of Wisconsin
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Commissioners:

In accordance with your instructions, a compliance examination has been made of the
affairs and financial condition of:

NORTHWESTERN NATIONAL CASUALTY COMPANY
Brookfield, Wisconsin

and this report is respectfully submitted.

I. INTRODUCTION

The previous examination of the company was conducted in 1999 as of December 31, 1998. The current examination covered the intervening period ending December 31, 2000, and included a review of such 2001 transactions as deemed necessary to complete the examination.

The examination consisted of a review of all major phases of the company's operations, and included the following areas:

- History
- Management and Control
- Corporate Records
- Conflict of Interest
- Fidelity Bonds and Other Insurance
- Employees' Welfare and Pension Plans
- Territory and Plan of Operations
- Affiliated Companies
- Growth of Company
- Reinsurance
- Financial Statements
- Accounts and Records
- Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comment on the remaining areas of the company's operations is contained in the examination work papers.

The examination was conducted in cooperation with the Texas Department of Insurance examination of Highlands Insurance Company and its affiliates. Examiners from this office and the Texas Department coordinated their testing work on the company's two computer platforms and shared workpapers relating to such testing.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

Actuary's Review

The Texas Insurance Department actuaries conducted a review of the adequacy of the group's pooled loss and loss adjustment expense reserves. The results of their work were reported to the examiner-in-charge. As deemed appropriate, reference is made in this report to the actuaries' conclusion.

II. HISTORY AND PLAN OF OPERATION

Northwestern National Casualty Company (NNCC) was organized on March 20, 1930, under the laws of Delaware. Northwestern National Casualty Company of Wisconsin was incorporated on November 11, 1963, under the laws of Wisconsin. On December 31, 1964, the two companies merged, with the Wisconsin Corporation being the surviving company. The “of Wisconsin” was omitted from the name, resulting in the name that is presently used. At that point, the company was controlled by Northwestern National Insurance Company of Milwaukee, Wisconsin. On December 1, 1989, a restructuring placed NNCC and its subsidiaries under the ownership of Northwestern National Holding Company, Inc. (NNHC), a Delaware corporation. On April 7, 1995, NNHC was acquired by Vik Brothers Insurance, Inc., an Indiana corporation. Highlands Insurance Group, Inc., a Delaware corporation, became the controlling affiliate of NNCC on April 30, 1997, when it acquired Vik Brothers Insurance, Inc., and its subsidiaries.

The company is licensed in the following states:

Alabama	Indiana	Nebraska	South Carolina
Arizona	Iowa	Nevada	South Dakota
Arkansas	Kansas	New Jersey	Tennessee
California	Kentucky	New Mexico	Texas
Colorado	Louisiana	North Carolina	Utah
Delaware	Maryland	North Dakota	Virginia
District of Columbia	Michigan	Ohio	Washington
Florida	Minnesota	Oklahoma	West Virginia
Georgia	Mississippi	Oregon	Wisconsin
Idaho	Missouri	Pennsylvania	Wyoming
Illinois	Montana	Rhode Island	

States in which the company wrote the most direct premium in 2000 were as follows:

	Direct Premium Written	% of Total
Pennsylvania	\$ 28,065,300	16.7%
Illinois	14,421,973	8.6
Indiana	10,869,318	6.5
Wisconsin	10,586,014	6.3
Iowa	10,349,569	6.2
Minnesota	10,256,720	6.1
All others	<u>83,192,906</u>	<u>49.6</u>
	<u>\$167,741,800</u>	<u>100.0%</u>

The major products marketed by the company include commercial multiple peril, workers compensation, homeowners, private passenger auto, and other lines, either written on a direct basis or assumed from affiliates under reinsurance contracts. The major products are marketed through approximately 1,752 agencies.

Corporate sales and marketing functions are performed in Brookfield Wisconsin, and Lawrenceville, New Jersey. Corporate underwriting functions are performed in Brookfield and Lawrenceville for commercial lines and Raleigh, North Carolina, for personal lines. These offices establish policies and procedures, and provide additional review and direction for risks exceeding regional office authority levels. The company has regional offices in Columbus, Ohio; Des Moines, Iowa; and Denver, Colorado where sales and underwriting of commercial lines take place. Billing and collection functions are performed in Brookfield and Lawrenceville.

The corporate claims function is located in Lawrenceville. The corporate claims function establishes policies and procedures, and provides additional direction for large/high exposure losses exceeding regional office authority levels. In addition, the corporate claim function is responsible for the billing and collection of reinsurance transactions and recoveries of salvage and subrogation. Claims are also processed in Des Moines, and Raleigh, except for first party auto claims, which are processed in Raleigh only.

The following table is a summary of the net insurance premiums written by the company in 2000. The growth of the company is discussed in the Financial Data section of this report.

Line of Business	Direct Premium	Reinsurance Assumed	Reinsurance Ceded	Net Premium
Fire	\$ 685,435	\$ 5,727,110	\$ 4,529,246	\$ 1,883,299
Allied lines	4,798,579	4,869,417	5,153,051	4,514,945
Farmowner's multiple peril	1,008,821	1,320,431	1,340,202	989,050
Homeowner's multiple peril	8,410,472	33,439,499	31,203,834	10,646,137
Commercial multiple peril	48,798,950	29,608,207	50,694,818	27,712,339
Ocean marine		1,102,707		1,102,707
Inland marine	2,394,633	2,873,443	2,455,332	2,812,744
Medical malpractice - occurrence	38,975	8,695	33,483	14,187
Earthquake	62,062	30,819	63,613	29,268
Worker's compensation	22,846,657	38,934,043	34,481,613	27,299,087
Other liability - occurrence	20,308,286	11,062,669	19,589,151	11,781,804
Other liability - claims made	731,330	336,535	723,851	344,014
Products liability - occurrence	1,586,607	721,729	1,318,846	989,490
Private passenger auto liability	11,070,338	7,595,629	14,298,973	4,366,994
Commercial auto liability	26,158,741	19,731,786	24,826,622	21,063,905
Auto physical damage	17,912,976	12,010,235	20,160,427	9,762,784
Aircraft (all perils)		8,383		8,383
Fidelity		(6,063)		(6,063)
Surety	19,214	699,245	18,726	699,733
Glass				
Burglary and theft	3,753	1,224	2,826	2,151
Boiler and machinery		377		377
International		(196,969)		(196,969)
Reinsurance—non-proportional assumed liability		114,656		114,656
Write-ins for other lines of business				
Lenders single interest	<u>905,968</u>	<u>271,790</u>	<u>905,968</u>	<u>271,790</u>
Total All Lines	\$167,741,797	\$170,265,597	\$211,800,582	\$126,206,812

III. MANAGEMENT AND CONTROL

Board of Directors

The board of directors consists of five members who are elected annually by NNHC, the sole shareholder. Officers are elected at the board's annual meeting. Members of the company's board of directors may also be members of other boards of directors in the holding company group. The board members currently receive no additional compensation for serving on the board.

As of July 1, 2001, the board of directors consisted of the following persons (updates are noted through December 31, 2001):

Name	Principal Occupation	Residence
Willis T. King, Jr.*	Chairman & CEO Highlands Insurance Group, Inc. (HIG)	Summit, NJ
Charles J. Bachand*	Sr. Vice President, Chief Financial Officer, Assistant Secretary, & Treasurer HIG	Skillman, NJ
John W. Cowley	President & Chief Operations Officer HIG	Newton, PA
David C. Donaldson	Sr. Vice President – Claims HIG	Chalfont, PA
Stephen L. Kibblehouse	Sr. Vice President, General Counsel, & Secretary HIG	Doylestown, PA

* - Willis T. King, Jr. and Charles J Bachand resigned in November 2001 and were replaced by the following individuals:

Name	Principal Occupation	Residence
Robert J. Brookes	Vice President, Assistant General Counsel, & Secretary HIG	Haddonfield, NJ
Georgean M. Wardzinski	Sr. Vice President – Human Resources, & Administration HIG	Moorsetown, NJ

Officers of the Company

The officers elected by the board of directors and serving at July 1, 2001 are as follows (updates are noted through December 31, 2001):

Name	Office	2000 Compensation
Willis T. King, Jr.*	Chairman & CEO	\$665,231
John W. Cowley	President & COO	398,718
Charles J. Bachand*	Sr. Vice President, CFO, Asst. Secretary, & Treasurer	269,252
David C. Donaldson	Sr. Vice President – Claims	206,812
Stephen L. Kibblehouse	Sr. Vice President, General Counsel, & Secretary	206,207
Drew J. Magee	Sr. Vice President – Field Operations	168,452
Robert E. Masterson (Replaced Robert C. Resch during 2001)	Sr. Vice President – Information Technology	182,188@
Georgian M. Wardzinski	Sr. Vice President – Human Resources, & Administration	165,000
Edward R. Lang, II (Replaced previously vacant position during 2001)	Sr. Vice President, & Chief Underwriting Officer	372,632@
Robert J. Brookes	Vice President, Asst. General Counsel, & Asst. Secretary	12,019
Michael J. Fanale	Vice President – Casualty Claims	161,044
Houston D. Hemp	Vice President – Property Claims	130,798
Pamela J. Olson	Vice President – Commercial Underwriting	129,128
Richard C. Plunkett	Vice President, & Chief Actuary	176,186
Laurie A. Ranegar	Vice President – Claim Field Operations	114,966
Armando Romeo*	Vice President – Field Support Underwriting	134,190
Ronald A. Stuepfert*	Vice President – Investments	160,812
Susan M. Taylor	Vice President – Personal Lines	115,346
David Vernon White	Vice President – Major Accounts	175,421

All officers are compensated by Highlands Insurance Group, Inc.

@ Newly elected in 2001. Amount represents projected 2001 compensation.

* - Willis T. King, Jr., Charles J Bachand, Ronald A. Stuepfert and Armando Romeo all resigned either at the end of 2000 or during 2001.

IV. AFFILIATED COMPANIES

NNCC is a member of a holding company system. The organizational chart below depicts the relationships among the affiliates in the group. A brief description of the significant affiliates of NNCC follows the organizational chart.

Organizational Chart As of December 31, 2000

- Highlands Insurance Group, Inc. (DE)
 - American Reliance, Inc. (IN)
 - Northwestern National Holding Company, Inc. (DE)
 - Northwestern National Casualty Company (WI)**
 - NN Insurance Company (WI)
 - State Capital Insurance Company (NC)
 - American Professionals Insurance Company (IN)
 - Certified Finance Corporation (TX)
 - Insurance Management Corporation (TX)
 - SICO, Inc. (IN)
 - Statesman Insurance Company (IN)
 - Timeco, Inc. (IN)
 - Pacific National Insurance Company (CA)
 - Pacific Automobile Insurance Company (CA)
 - Highlands Holding Co., Inc.
 - Highlands Insurance Company
 - Highlands Underwriters Insurance Company
 - Highlands Casualty Company
 - Aberdeen Insurance Company
 - Underwriters Special Risks, Inc.
 - Highlands Lloyds
 - Highlands Claims and Safety Services
 - Highlands Holdings (UK) Ltd.
 - Highlands Insurance Company (UK) Ltd.
 - Highlands Underwriting Agents Ltd.
 - Highlands Ltd.
 - Highlands Overseas Limited
 - Highlands Services Corp.

Highlands Insurance Group, Inc. (HIG)

HIG is an insurance holding company with offices in Lawrenceville, New Jersey and the ultimate parent of NNCC. Until January 23, 1996, HIG was owned by Halliburton Company. On that date, the shares of HIG's common stock were distributed to Halliburton's stockholders in the form of a dividend. HIG is publicly traded on the New York Stock Exchange under the symbol "HIC". Additional comment on Highlands Insurance Group, Inc. can be found in the "Subsequent Events" section of this report.

As of December 31, 2000, HIG's audited consolidated financial statements reported assets of \$1.2 billion, liabilities of \$1 billion, and total stockholders' equity of \$203 million on a GAAP basis. Operations for 2000 produced a net loss of \$45 million.

Northwestern National Holding Company, Inc.

As NNCC's direct parent, this holding company is engaged in insurance activities through NNCC and other subsidiaries. As of December 31, 2000, the company's unaudited consolidated financial statements reported assets of \$484,178,645, liabilities of \$363,026,482 and stockholder's equity of \$121,152,163 on a GAAP basis. Operations for 2000 produced net loss of \$32,078,516.

NN Insurance Company (NNIC)

NNIC is a Wisconsin-domiciled property and casualty insurer and a wholly owned subsidiary of NNCC. NNIC was examined concurrently with NNCC. NNIC writes workers compensation, commercial multiple peril, and other commercial and personal lines of business, and cedes 100% of its business to NNCC. Direct premium written for 2000 totaled approximately \$28 million. As of December 31, 2000, the company's audited statutory-basis annual statement reported admitted assets of \$7,948,131, liabilities of \$47,312, and capital and surplus of \$7,900,817. The company reported \$330,382 of net income in 2000.

American Professionals Insurance Company

This Indiana-domiciled subsidiary of NNCC writes primarily homeowners and fire insurance policies in North and South Carolina. The company cedes 100% of its business to NNCC, which amounted to almost \$11.5 million of premiums in 2000. As of December 31, 2000, the company's audited statutory-basis annual statement reported admitted assets of \$6,643,569, liabilities of \$538,992, and capital and surplus of \$6,104,576. The company reported \$112,403 of net income in 2000.

State Capital Insurance Company

This North Carolina-domiciled subsidiary of NNCC writes homeowners and other personal lines. The company cedes 100% of its business to NNCC, which amounted to almost \$30 million of premiums in 2000. The company writes business primarily in North Carolina, New

Jersey, South Carolina, and other nearby states. As of December 31, 2000, the company's audited statutory-basis annual statement reported admitted assets of \$7,243,127, liabilities of \$2,185, and capital and surplus of \$7,240,943. The company reported \$392,707 of net income in 2000.

Affiliated Agreements

Most of the companies in the group, including NNCC, have entered into a Group Services Agreement, which provides for the reimbursement of expenses incurred by one company in the group for the benefit of an affiliate. The majority of services provided under this agreement relate to general overhead, investment services, and unallocated loss adjusting expenses that are initially paid by Highlands Insurance Company.

V. REINSURANCE

The company's reinsurance portfolio and strategy is described below. A list of the companies that have a significant amount of reinsurance in force at the time of the examination follows. The contracts contained proper insolvency provisions.

Affiliated Reinsurance

NNCC assumes 100% of the premiums written by four of its subsidiaries:

Ceding Company	Effective Date
NN Insurance Company	September 1, 1987
State Capital Insurance	January 1, 1998
American Professionals Insurance Company	January 1, 1998
Statesman Insurance Company	January 1, 1991

NNCC cedes 100% of its net retained business to the Highlands Insurance Group reinsurance pool under an agreement effective January 1, 2000. The Highlands pool then cedes a small percentage to unaffiliated reinsurers. Highlands retains 70% of its net risk after unaffiliated reinsurance and retrocedes 30% back to NNCC.

Reinsurance Ceded

The company retains \$500,000 per occurrence for casualty business including workers' compensation. For property business, the company retains \$500,000 per risk with an annual aggregate deductible of \$1,000,000. Losses accumulating towards the satisfaction of the annual aggregate deductible are limited to \$250,000 per occurrence. In addition, the company's property losses resulting from a catastrophic occurrence are limited to \$5,000,000 per occurrence plus 5% of the next \$5,000,000, plus 2.5% of the next \$10,000,000.

Significant reinsurers at the time of the examination included the following companies:

Hannover Ruckversicherungs A. G.
Folksamerica Reinsurance Co
PMA Reinsurance
Employers Reinsurance Corp
Erie Insurance Exchange
St Paul Fire and Marine Ins Co
Partner Re
Gerling Global

VI. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported in the December 31, 2000, annual statement to the Commissioner of Insurance. Also included in this section are schedules which reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Surplus per Examination."

Northwestern National Casualty Company
Assets
As of December 31, 2000

	Ledger Assets	Nonledger Assets	Nonadmitted Assets	Admitted Assets
Bonds	\$135,551,237	\$	\$	\$135,551,237
Stocks:				
Preferred stocks	11,066,383	(293,963)		10,772,420
Common stocks	28,014,043	1,141,532		29,155,575
Real estate:				
Occupied by the company	5,292,324			5,292,324
Cash	16,447,688			16,447,688
Short-term investments	13,366,137			13,366,137
Other invested assets	1,584			1,584
Receivable for securities	657,327			657,327
Agents' balances or uncollected premiums:				
Premiums and agents' balances in course of collection	27,549,662		4,193,816	23,355,846
Premiums, agents' balances, and installments booked but deferred and not yet due	15,418,779			15,418,779
Reinsurance recoverables on loss and adjustment payments	(715,440)			(715,440)
Federal income tax recoverable and interest thereon		2,235,079		2,235,079
Guaranty funds receivable or on deposit	75,093			75,093
Electronic data processing equipment	1,225,292			1,225,292
Interest, dividends, and real estate income due and accrued		2,388,036		2,388,036
Equities and deposits in pools and associations	1,088,452			1,088,452
Other assets nonadmitted:				
Equipment, furniture, and supplies	632,777		632,777	
Write-ins for other than invested assets				
Ceded contingent commissions recoverable	726,578			726,578
Collateral Reliance Surety Bond	5,320,000			5,320,000
Miscellaneous Assets	(164,353)			(164,353)
NCRF Recoupment	<u>1,490,086</u>	<u> </u>	<u>203,672</u>	<u>1,286,414</u>
Total Assets	<u>\$263,043,649</u>	<u>\$ 5,470,684</u>	<u>\$ 5,030,265</u>	<u>\$263,484,068</u>

Northwestern National Casualty Company
Liabilities, Surplus, and Other Funds
As of December 31, 2000

Losses	\$113,701,913
Reinsurance payable on paid loss and loss adjustment expenses	300,854
Loss adjustment expenses	26,101,202
Contingent commissions and other similar charges	2,403,017
Other expenses (excluding taxes, licenses, and fees)	12,153,060
Taxes, licenses, and fees (excluding federal and foreign income taxes)	3,062,540
Unearned premiums	51,359,738
Dividends declared and unpaid:	
Policyholders	1,800,261
Funds held by company under reinsurance treaties	1,057
Amounts withheld or retained by company for the account of others	459,449
Provision for reinsurance	955,380
Excess of statutory over statement reserves	219,727
Drafts outstanding	23,952
Payable to parent, subsidiaries, and affiliates	860,659
Write-ins for liabilities:	
Escrow Premium Payable	<u>231,855</u>
 Total Liabilities	 213,634,664
 Write-ins for special surplus funds:	
Undeclared policyholder dividends	1,829,997
Common capital stock	3,500,000
Gross paid in and contributed surplus	59,414,230
Unassigned funds (surplus)	<u>(14,894,823)</u>
 Surplus as Regards Policyholders	 <u>49,849,404</u>
 Total Liabilities, Surplus, and Other Funds	 <u>\$263,484,068</u>

Northwestern National Casualty Company
Summary of Operations
For the Year 2000

Underwriting Income

Premiums earned	\$ 98,736,119
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Deductions

Losses incurred	92,153,112
Loss expenses incurred	8,216,573
Other underwriting expenses incurred	<u>37,142,726</u>

Total underwriting deductions	<u>137,512,411</u>
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Net underwriting loss	(38,776,292)
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Investment Income

Net investment income earned	13,104,542
Net realized capital gains or losses	<u>(285,081)</u>
Net investment gain or loss	12,819,461

Other Income

Net gain or (loss) from agents' or premium balances charged off	(233,882)
Finance and service charges not included in premiums	650,440
Write-ins for miscellaneous income:	
Miscellaneous Income	125,333
Penalties and Fines	(321,976)
Other Taxes	<u>(63,810)</u>
Total other income	<u>156,105</u>

Net income before dividends to policyholders and before federal and foreign income taxes	(25,800,726)
Dividends to policyholders	<u>472,102</u>

Net income after dividends to policyholders but before federal and foreign income taxes	(26,272,827)
Federal and foreign income taxes incurred	<u>49,002</u>

Net Loss	<u><u>\$ (26,321,829)</u></u>
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Northwestern National Casualty Company
Cash Flow
As of December 31, 2000

Premiums collected net of reinsurance	\$86,037,278		
Loss and loss adjustment expenses paid (net of salvage or subrogation)	93,221,194		
Underwriting expenses paid	<u>33,173,564</u>		
Cash from underwriting		\$(40,357,480)	
Investment income (net of investment expense)		13,097,843	
Other income (expenses):			
Agents' balances charged off	(233,882)		
Net funds held under reinsurance treaties	878		
Net amount withheld or retained for account of others	27,865		
Write-ins for miscellaneous items:			
Equities and deposits in pools and Associations	233,973		
Finance and service fees	650,437		
Miscellaneous income	<u>(260,453)</u>		
Total other income		418,818	
Deduct:			
Dividends to policyholders paid		178,649	
Federal income taxes paid (recovered)		<u>12,272</u>	
Net cash from operations			\$(27,031,740)
Proceeds from investments sold, matured, or repaid:			
Bonds	69,044,073		
Stocks	7,378,798		
Miscellaneous proceeds	<u>1,287,724</u>		
Total investment proceeds		77,710,595	
Cost of investments acquired (long-term only):			
Bonds	26,815,366		
Stocks	199,958		
Real estate	<u>5,292,324</u>		
Total investments acquired		<u>32,307,648</u>	
Net cash from investments			45,402,947
Cash provided from financing and miscellaneous sources:			
Net transfers from affiliates	4,597,392		
Other cash provided	<u>118,504</u>		
Total		4,715,896	
Cash applied for financing and miscellaneous uses:			
Other applications	<u>696,285</u>		
Total		<u>696,285</u>	
Net cash from financing and miscellaneous sources			<u>4,019,611</u>
Net change in cash and short-term investments			22,390,818
Reconciliation			
Cash and short-term investments, December 31, 1999			<u>7,423,007</u>
Cash and short-term investments, December 31, 2000			<u>\$ 29,813,825</u>

Northwestern National Casualty Company
Compulsory and Security Surplus Calculation
December 31, 2000

Assets		\$263,484,068	
Less investment in insurance subsidiaries not in excess of subsidiaries' security surplus		5,600,000	
Less liabilities		<u>213,634,664</u>	
Adjusted surplus			\$44,249,404
Annual premium:			
Individual accident and health	\$		
Factor	<u>15%</u>		
Total			
Group accident and health			
Factor	<u>10%</u>		
Total			
All other insurance	125,734,710		
Factor	<u>20%</u>		
Total		<u>25,146,942</u>	
Compulsory surplus (subject to a minimum of \$2 million)			<u>25,146,942</u>
Compulsory surplus excess (or deficit)			<u>\$19,102,462</u>
Adjusted surplus			\$44,249,404
Security surplus:			
(140% of compulsory surplus, factor reduced 1% for each \$33 million in premium written in excess of \$10 million with a minimum of 110%)			<u>34,451,311</u>
Security surplus excess (or deficit)			<u>\$ 9,798,093</u>

* - The Compulsory and Security surplus calculations above are those reported by the company as of December 31, 2000. See the sections of this report titled "Summary of examination results" for examination adjustments and "Subsequent event" section concerning company actions as a result of continued deterioration of capital related to the poor 2001 operational results.

Northwestern National Casualty Company
Reconciliation and Analysis of Surplus
For the Three-Year Period Ending December 31, 2000

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

	1998	1999	2000
Surplus, beginning of year	\$85,127,735	\$80,408,677	\$76,271,702
Net income	5,943,140	(5,427,756)	(26,321,829)
Net unrealized capital gains or (losses)	(5,456,890)	4,036,385	1,697,388
Change in nonadmitted assets	(3,167,243)	12,799,972	(1,884,139)
Change in provision for reinsurance	(375,346)	(358,922)	(125,054)
Change in excess of statutory reserves over statement reserves	(312,441)	2,673,700	211,314
Surplus changes:			
Paid-in	7,149,722		
Dividends to stockholders	(8,500,000)	(5,000,000)	
Surplus, end of year	<u>\$80,408,677</u>	<u>\$76,271,702</u>	<u>\$49,849,381</u>

Northwestern National Casualty Company
Insurance Regulatory Information System
For the Three-Year Period Ending December 31, 2000

The following is a summary of NAIC Insurance Regulatory Information System (IRIS) results for the period under examination. Exceptional ratios are denoted with asterisks. A discussion of the exceptional ratios may be found after the IRIS ratios

	Ratio	1998	1999	2000
#1	Gross Premium to Surplus	234.0%	243.0%	678.0%
#1A	Net Premium to Surplus	211.0	145.0	253.0
#2	Change in Net Writings	7.0	-35.0*	14.0
#3	Surplus Aid to Surplus	0.0	1.0	0.0
#4	Two-Year Overall Operating Ratio	92.0	105.0*	113.0*
#5	Investment Yield	9.9	6.5	6.0
#6	Change in Surplus	-3.0	-18.0*	-26.0*
#7	Liabilities to Liquid Assets	95.0	96.0	108.0*
#8	Agents' Balances to Surplus	9.0	15.0	47.0*
#9	One-Year Reserve Devel. To Surplus	-14.0	-3.0	26.0*
#10	Two-Year Reserve Devel. To Surplus	-48.0	-22.0	10.0
#11	Estimated Current Reserve Def. To Surplus	7.0	18.0	-80.0

The company's poor operating results during 1999 and 2000, including significant calendar year 2000 reserve development, substantially decreased surplus and invested assets which caused many of the exceptional IRIS ratios noted above. Ratio No. 2 was exceptional in

1999 due to a quota share agreement effective December 31, 1999 that ceded \$60 million in unearned premium from NNCC to HIC in anticipation of the pooling agreement effective January 1, 2000. For additional comment in regards to the pooling agreement, see the section of this report titled "Reinsurance".

Growth of Northwestern National Casualty Company

Year	Admitted Assets	Liabilities	Surplus As Regards Policyholders	Net Income
1998	\$368,693,346	\$288,284,671	\$80,408,677	\$5,943,140
1999	254,826,802	178,555,102	76,271,702	(5,427,756)
2000	263,484,068	213,634,664	49,849,404	(26,321,829)

Year	Gross Premium Written	Net Premium Written	Premium Earned	Loss And LAE Ratio	Expense Ratio	Combined Ratio
1998	\$188,350,686	\$169,732,366	\$158,971,749	70.9%	41.6%	112.5%
1999	185,130,156	110,698,880	161,345,290	76.8	48.2	125.0
2000	338,007,394	126,206,812	98,736,119	101.7	29.3	131.0

The company's assets and surplus has decreased significantly during the examination period. During 2000, operating results were negatively impacted by adverse loss reserve development on the group's commercial multi-peril and workers' compensation lines of business, mainly the 1998 and 1999 accident year. In addition, management increased loss reserves on the 2000 accident year during the fourth quarter, as a result of the adverse loss reserve development that was experienced on the 1999 accident year.

The company has continued to reduce staffing levels in an effort to reduce its traditionally high expense ratio that is demonstrated by the lower expense ratio in 2000 as compared to the preceding two years. Additional reductions are expected and discussed further in the section of this report titled "Subsequent Event".

NNCC's net premium written decreased significantly due to the new pooling agreement that was effective January 1, 2000. However, the gross premium written increased significantly as the group pursued perceived market opportunities. For additional information regarding the new pooling agreement see the section of this report titled "Reinsurance".

Reconciliation of Surplus per Examination

The following schedule is a reconciliation of members' surplus between that reported by the company and as determined by this examination:

Surplus December 31, 2000, per annual statement			\$49,849,404
	Increase	Decrease	
Preferred stock	\$	\$3,403,910	
Real estate		291,628	
Cash		2,825,033	
Premiums, agents' balances in course of collection		98,164	
Funds held by or deposited with various reinsured companies		7,046,212	
Federal income tax recoverable and interest thereon		2,235,079	
Electronic data processing equipment		218,953	
Interest, dividends and real estate income due accrued		45,162	
Ceded contingent commissions recoverable		726,578	
Unpaid losses		4,500,000	
Provision for reinsurance		<u>32,094</u>	
Net increase or (decrease)	<u>\$</u>	<u>\$21,422,813</u>	<u>(21,422,813)</u>
Surplus December 31, 2000, per examination			<u>\$ 28,426,591</u>

Examination Reclassifications

	Debit	Credit
Cash and short-term investments	\$	\$14,626,754
Funds held by or deposited with various reinsured companies	7,046,212	
Receivable from parent, subsidiaries and affiliates	7,580,542	
Unearned premiums	8,624,172	
Payable to parent, subsidiaries and affiliates		<u>8,624,172</u>
Total reclassifications	<u>\$23,250,926</u>	<u>\$23,250,926</u>

VII. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

There were 14 specific comments and recommendations in the previous examination report. Comments and recommendations contained in the last examination report and actions taken by the company are as follows:

1. Transition of Ownership—It is recommended that the company thoroughly review the general ledger system, document the purpose of each account, and ascertain if the account is being used as intended.

Action—Noncompliance, see comments in the summary of current examination results.

2. Business Plan—It is recommended that the company create a formal comprehensive business plan.

Action—Compliance.

3. Report of Executive Compensation—It is again recommended that the company complete its Report of Executive Compensation in a consistent manner pursuant to the instructions on the form.

Action—Compliance.

4. Information Technology—It is recommended that the company establish a procedure that documents that the user is satisfied that an IT project was completed to his or her satisfaction.

Action—Compliance.

5. Information Technology—It is recommended that the company establish a control that periodically validates access rights of users to ensure that an individual's access rights reflect his or her job responsibilities.

Action—Compliance.

6. Information Technology—It is recommended that the company establish the necessary procedures such that a log of security violations is maintained and reviewed daily.

Action—Compliance.

7. Disaster Recovery Plan—It is recommended that the company create a disaster recovery plan that addresses issues necessary for the company to continue operations in the event of a disaster. It is further recommended that the plan be completed by December 31, 2000, and subsequently reviewed, tested, and updated at least annually.

Action—Noncompliance, see comments in the summary of current examination results.

8. Claim Files—It is recommended that the company improve its procedures regarding the maintenance of claim files to prevent files from being lost.

Action—Noncompliance, see comments in the summary of current examination results.

9. Common Stocks—It is recommended that the company report the value of its common stock investments in affiliated companies to the SVO as required by the Purposes and Procedures Manual of the NAIC Securities Valuation Office.

Action—Compliance.

10. Cash—It is recommended that the company reconcile all bank accounts on a monthly basis and take the necessary steps to clear reconciling items so they are not present on subsequent reconciliations.

Action—Noncompliance, see comments in the summary of current examination results.

11. Cash—It is recommended that in future annual statements, the company exclude from the cash balance suspense items and other items that do not meet the definition of cash. Such items should be classified in the appropriate annual statement line.

Action—Noncompliance, see comments in the summary of current examination results.

12. Reinsurance Recoverable on Loss and Loss Adjustment Expense Payments—It is recommended that the company review the systems and procedures used for recording reinsurance recoverables and recoveries, and develop procedures that will enable the company to provide detailed documentation that supports the annual statement balance.

Action—Noncompliance, see comments in the summary of current examination results.

13. Other Expenses—It is recommended that in future annual statements, the company classify accrued commissions, taxes, and other items in compliance with the NAIC Annual Statement Instructions—Property and Casualty.

Action—Noncompliance, see comments in the summary of current examination results.

14. Provision for Reinsurance—It is recommended that in future annual statements, the company complete Schedule F, Part 7, in compliance with the Annual Statement Instructions—Property and Casualty.

Action—Noncompliance, see comments in the summary of current examination results.

Summary of Current Examination Results

Conflict of Interest Disclosures

A directive issued by Wisconsin's Commissioner of Insurance requires companies to implement and enforce a procedure under which all directors and key officers complete a conflict of interest statement annually to disclose any material interest or affiliation which is in or is likely to conflict with their official duties. The examiners requested the most current conflict of interest disclosures and were provided disclosures that were completed and signed in previous years. Accordingly, this examination concluded that NNCC's directors and officers were not in the practice of completing a statement of this type on a yearly basis. It is recommended that the company implement a procedure for the annual completion of conflict of interest statements by the officers and directors, and that such statements be maintained for review.

Disaster Recovery Plan

The previous and current examination noted that although some companies in the group have a disaster recovery plan, NNCC and other subsidiaries of American Reliance Inc. do not. It is again recommended that the company create a disaster recovery plan that addresses issues necessary for the company to continue operations in the event of a disaster. It is further recommended that the plan be completed, within 90 days from the adoption of this report, and subsequently reviewed, tested, and updated at least annually.

Claim Files

As part of a test of the accuracy of the company's claims system, a sample of claim files was requested by the examiners. After several weeks, the company determined that it was unable to locate one of the requested files. In order for the company to have an adequate system of internal controls and record retention, it is important that source documents be maintained to support data on the systems. A similar occurrence was noted in the previous examination. It is again recommended that the company improve its procedures regarding the maintenance of claim files to prevent files from being lost.

Reinsurance Contracts

The examiners requested access to signed executed agreements to substantiate the relationship between the company and its various reinsurers. After several months of fieldwork, the company was able to produce the majority of the placements, including the placements through brokers. According to the NAIC Accounting Practices and Procedures Manual—Property and Casualty "...if a contract entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and must be accounted for as a retroactive reinsurance contract." The reinsurance contracts in question related to contracts with more than one reinsurer and the company was able to provide signed executed agreements that represented more than 50% of the capacity on the contract; in accordance with the NAIC Accounting Practices and Procedures Manual no retroactive treatment was necessary. However, in order to ensure that this treatment would not be necessary in the future, it is recommended that the company obtain and retain signed executed reinsurance contracts and have readily available for future inspections from this office.

Company personnel disclosed that, on a periodic basis, they monitor the financial condition of the reinsurance companies with which it places significant reinsurance coverage and strives to place reinsurance coverage with financially sound reinsurance companies. The examiners requested the latest review, but were informed that the company does not retain any documentation of the reviews conducted. Retention of such reviews would not only provide documentation to substantiate the review process, but may also simplify comparisons that may be drawn from changes in the financial condition of various reinsurers from one period to the next. It is recommended that the company retain documentation of its review of the financial condition of reinsurance companies it places significant reinsurance coverage with to ensure placements are made according to company guidelines.

The previous examination found the company's documentation of the reinsurance recoverable balances and reinsurance recovery procedures to be inadequate. NNCC was unable

to provide detailed data showing the claims that comprised certain balances within the amount recoverable as of December 31, 1998.

The current examination sent confirmations to reinsurers with which the company was anticipating recoveries. These confirmations revealed instances in which the company had communicated changes pertaining to specific case reserves properly to the reinsurer and the reinsurer had reported the appropriate payable, but the company had yet to record the appropriate change in its own ledger system. It is again recommended that the company review the systems and procedures used for recording reinsurance recoverables and recoveries, and develop procedures that will enable the company to provide detailed documentation that supports the annual statement balance.

In addition to the above-mentioned inadequacies identified with confirmations, the examiners' review identified errors associated with numerous balances reported in Schedule F. Examples included: misallocation between reinsurance companies, incorrectly reported balances between affiliates that included cessions made in previous years and incorrect identification numbers recorded for various reinsurers. While these errors did not result in examination adjustments it did contribute to reclassifications discussed in the section of the report titled "Unearned Premium". It is recommended that in future annual statements, the company complete Schedule F, in compliance with the NAIC Annual Statement Instructions – Property and Casualty.

Transition of Ownership

The prior examination report noted numerous changes the company was implementing as a result of the acquisition of NNCC in 1997. One of the more significant changes resulted from NNCC transferring accounting operations from Brookfield, Wisconsin to its Houston, Texas location. Many of the previous examiners' findings appeared to be the result of the company's inexperience with the transferred functions. In addition, the lack of timely reconciliations was identified as exacerbating the problem, particularly in the cash and premium accounts. These deficiencies resulted in unidentified ledger entries and unusual general ledger balances that required numerous adjustments in order for the company to derive the 1998 annual statement balances.

In addition to the accounting function, many systems were combined or replaced, as several system upgrades were needed in order to make all systems Y2K compliant.

The previous examination's fieldwork was performed in the fall of 1999, more than two years after HIG acquired the company, and a year after the accounting operations were transferred to Houston.

The current examination observed that several unreconciled or unidentified balances continue to exist, these balances caused audit trails that were sometimes difficult to follow, and in some cases, the company was unable to provide documentation for annual statement balances in a timely manner. Ultimately, these issues resulted in numerous examination reclassifications and/or adjustments, as company personnel misclassified several accounts, apparently due to lack of knowledge of items contained within the various accounts. It is again recommended that the company, within 60 days' from the adoption of this report, thoroughly review the general ledger system, document the purpose of each account, ascertain if the account is being used as intended, and submit documentation of its completion with this office.

Preferred Stock **\$7,368,510**

The asset includes a decrease of \$3,403,910 made by the examination. The company was unable to substantiate a market value for the stock. Accordingly, the examination nonadmitted the entire value associated with its purchase including accrued dividends reported at year-end in the amount of \$45,162.

Cash **\$12,362,038**

During the previous examination the group's system for recording and monitoring cash was found to be cumbersome and prone to errors that required extensive reconciliation. In 1998, the cash account for each company in the group consisted of numerous bank accounts in various locations. Regional offices issued their own checks, making it difficult for NNCC to precisely determine the last check written and exactly which checks were outstanding at year end. The previous examiners noted that NNCC did not reconcile bank accounts for many months at a time in 1998. For one account, the reconciliation as of December 31, 1998 was still in progress at the time of the previous examination in October 1999.

The previous examination concluded that many of the problems appear to have been the result of HIG inheriting a very complicated and inefficient cash system. The gradual efforts by the company to improve the cash system including centralizing the cash function in Houston in 1999 and closing some accounts, was acknowledged.

The current examination noted that the company has continued attempts to correct this situation. However, many of the same reconciling items referenced in the previous report were present in September 2001. The current reconciliations included headers such as "Unexplained balance carryover", which included items that were unexplained from previous ledger systems from December of 1997, as well as other instances of outdated unexplained differences. The company contended that many of these items were the result of a decision not to carryforward to the new systems, claims that were identified as closed. While many closed claims would be expected to have little to no activity, there are occasions that the company was still waiting for several items to either clear banks such as salvage and subrogation or disbursements. Company personnel, responsible for cash reconciliations, no longer had access to the data necessary to clear these items on the new system. In order to clear these items company personnel would have to manually request source documentation to individually identify the cause of the reconciling item. At the time of fieldwork the company indicated that several new employees were hired to assist in the company's efforts to clear these items.

The company's current treatment of these unexplained differences was to accept both the increases and the decreases to cash, with no apparent regard to the appropriateness of the offsetting or consideration to the age of the items. Given the fact that the company was both unable to identify the specific reconciling items or able to clearly substantiate that the offsetting was appropriate, the examination took a more conservative approach. This approach did allow some offsetting of unreconciling items within the same years, as well as the same systems, but the net increase to cash of \$2,726,944 was nonadmitted. In order to assure the timely reconciliation of bank accounts in the future, it is again recommended that the company reconcile all bank accounts on a monthly basis and take the necessary steps to clear reconciling items so they are not present on subsequent reconciliations.

The previous examination noted that this asset included several general ledger balances that represented cash-related items other than cash deposits or petty cash. These items are usually temporary in nature; for example, subrogation receipts are temporarily held in an account until the specific classification is identified. The examination concluded that these accounts would be better classified as one of the following annual statement lines:

Amounts withheld or retained by company for the account of others
Remittances and items not allocated
Payable to parent, subsidiaries, and affiliates
Receivable from parent, subsidiaries, and affiliates

The current examination noted several items that continued to be reported as cash that appeared would have been better reported within the aforementioned accounts. One such instance related to a significant claim payment that was inadvertently charged to NNCC that should have been charged to Highlands. The examination reclassified \$7,580,542 from “Cash and Short-Term Investments” to “Receivable from Parent, Subsidiaries and Affiliates” that related to this specific item. Other potential reclassifications related to this account were not deemed necessary, since the net of these balances was not considered material. However, it is again recommended that in future annual statements, the company exclude from the cash balance suspense items and other items that do not meet the definition of cash. Such items should be classified in the appropriate annual statement line.

In addition, during November of 2000, the company made a corporate capital investment in two Lloyd’s Syndicates, that required deposits totaling \$7,046,212. The investment is administered through separate Quota Share Treaties and creates a Reinsurer/Reinsured relationship between the parties, with NNCC being identified as the Reinsurer. The examination determined that these deposits are better classified as “Funds held by or deposited with reinsured companies”. According to the NAIC Accounting Practices and Procedures Manual—Property and Casualty, funds held by or deposited with reinsured companies, are admitted assets provided they do not exceed the liabilities they secure and provided the reinsured is solvent. Those funds which are in excess of the liabilities, and any funds held by insolvent reinsureds, should be nonadmitted. The contracts were not effective until January 1, 2001 and no liabilities existed at year-end. As a result, the examination nonadmitted both deposits.

The asset also includes a decrease of \$98,089 made by the examination. The examination identified several closed bank accounts that the company had inadvertently continued to attribute value to on its general ledger system. These adjustments are included within “Misc. Trial Balance Items” in the section of this report titled “Reconciliation of Surplus per Examination”.

Real Estate **\$5,000,696**

This asset reported above also includes a decrease of \$291,628 made by the examination. This asset is entirely comprised of home office facilities located in Lawrenceville, New Jersey. The examination adjustment is a result of the company improperly calculating the depreciation of the building. It is recommended that the company properly depreciate the cost of property, other than land, over its estimated useful life, in accordance to the NAIC Accounting Practices and Procedures Manual – Property and Casualty.

Premiums, Agents’ Balances In Course of Collection **\$23,257,682**

This asset reported above also includes a decrease of \$98,164 made by the examination. The examination adjustment is a result of the company improperly carrying forward premium receivable balances, from previous ledger systems, that were significantly greater than 90 days past due.

Federal Income Tax Recoverable and Interest Thereon **\$0**

This asset was entirely comprised of federal income tax recoverables due NNCC from American Reliance Inc., an affiliate, and includes a decrease of \$2,235,079 made by the examination. According to the NAIC Accounting Practices and Procedures Manual—Property and Casualty “To the extent that the affiliate has liquid assets with which to repay the balance, and to otherwise maintain its account on a current basis, the amount may be admitted.” The examination discovered that the entire balance was due NNCC since April of 1997 and accordingly nonadmitted the entire balance, due to the affiliate not maintaining a current balance.

Electronic Data Processing Equipment**\$1,006,339**

This asset reported above includes a decrease of \$218,953 made by the examination. The decrease resulted from an apparent transposition error made when the recording of a computer purchase and is shown net of accumulated depreciation.

Ceded Reinsurance Commissions Receivable**\$0**

This asset includes a decrease of \$726,578 made by the examination. Included within "Aggregate Write-Ins For Other Than Invested Assets" were several sliding scale contingent commission accruals that were established in prior years. The accruals were not adjusted based on current year-end information. The company was required to recalculate the accruals and determined no sliding scale contingent commissions were receivable.

According to the NAIC Annual Statement Instructions—Property and Casualty ceded reinsurance commissions receivable should be reported as an offset to ceded reinsurance commissions payable. The examination made no reclassification due to the balances not being considered receivable. However, it is recommended that in the future, the company report ceded reinsurance commissions receivable as an offset to ceded reinsurance commissions payable, in compliance with the NAIC Annual Statement Instructions—Property and Casualty.

Unpaid Losses**\$113,701,913**

This liability represents the company's estimate of amounts payable on losses incurred on or prior to December 31, 2000, and remaining unpaid as of that date. The examination in coordination with the Texas Insurance Department reviewed the methodology used to establish the reserves as well as tested the underlying data that was used to determine the basis for such estimates. The examination's efforts were complicated by system problems encountered by the company that raised concerns with the integrity of the underlying data used to establish the company's reserves. The group appeared to experience significant difficulties as a result of the its efforts to make all systems Y2K compliant.

The most significant difficulty related to a run-off claim handling system installed after September 1999 identified as the NN Clone Claim Handling System (NN CHS). This system was

developed to allow for the continued processing of claims attached to policies issued prior to December 31, 1998 and established under various other claim systems.

During early 2000, several field offices had reported to the company mis-matches between the NN CHS Clone data and the Management Information Platform (MIP, the General Ledger Feed) data warehouse reports. Although these isolated discrepancies were identified, it was not until a review of all large claims identified a payment discrepancy in August of 2000, that the problem was traced to the NN CHS system and the full scope of the out-of-balance condition was identified.

Further analysis confirmed that a significant out-of-balance condition did exist in the NN CHS system and that a number of claim transactions had not been updated to MIP and, ultimately, to the general ledger. This condition began in October 1999. The estimated total of all payments and reserve changes that had not flowed through MIP was approximately \$25 million. It is recommended that the company improve controls associated with implementation of new data systems to ensure systems work as intended. Examples of improved controls may include parallel testing and run-to-run comparisons. These controls may not only identify the above mentioned conditions in a more timely manner, but possibly before implementation and reliance on the new systems. The company contended that both its in-house actuarial department and outside opining actuaries were provided these changes to reserves and had incorporated these changes correctly in its reserves.

During initial examination planning discussions, the company acknowledged that Schedule P contained misallocation between years and other inaccuracies related to pooled business reporting requirements outlined in the NAIC Annual Statement Instructions—Property and Casualty. The company identified that these problems originated from 1) system problems explained earlier and 2) unfamiliarity with the new pooling arrangement effective January 1, 2000. These issues contributed to extensive discussions with outside actuaries that resulted in the company's Financial Reporting Department receiving data necessary for the completion of Schedule P much later than usual and ultimately caused the company to file annual statements late with various state insurance departments. It is recommended that in future Annual

Statements, the company complete Schedule P in compliance with the NAIC Annual Statement Instructions—Property and Casualty.

The examiners in coordination with the Texas Insurance Department determined that testing would concentrate on data provided to its outside actuaries and the company would continue efforts to reconcile Schedule P to the actuarial data. After numerous attempts the company was eventually able to reconcile the data on a net aggregate basis. However, while the reconciliation included differences between specific accident years in excess of 10%, these offsetting differences resulted in a 0.77% net aggregate difference. At the time of fieldwork, the company had plans to internally restate Schedule P in December 2001 and incorporate changes in subsequent Annual Statements.

The examination's review of the underlying data included testing, on a sample basis, of the case reserve and payment data to documentation included within the actual claim files and review of the subsequent development of year-end reserves. This review provided examples of errors that may have contributed to the misallocation between years previously described. An example of this misallocation between accident years was identified during the review of Schedule P, Part 1A – Homeowners/Farmowners of the 2000 Annual Statement. The company had reported negative ceded case reserves of approximately \$1 million for accident year 1997 and a positive ceded case reserve of \$1.3 million for accident year 1999. The error resulted from manual case reserve adjustments due to Hurricane Floyd that was incorrectly applied to accident year 1997. The company anticipates correcting this and other identified allocation errors in the revised 2000 Schedule P.

The examination reviewed the Highlands Insurance Group's and NNCC's reported results during 2001. The Highlands Insurance Group reported a net loss of \$30.5 million, with NNCC's reported net loss of \$17.9 million, through the third quarter of 2001. Adverse loss reserve development included in the nine months of 2001 totaled approximately \$52.8 million for the Highlands Insurance Group, with NNCC's contributing approximately \$12.2 million.

The Texas Department of Insurance actuaries performed an independent analysis of the net loss reserves and loss adjustment reserves and recommended an increase of \$4,500,000

to be made to the company's net loss reserves as of December 31, 2000. An adjustment reflecting the increase to net loss reserves and loss adjustment reserves and a decrease to surplus can be found in the "Reconciliation of Surplus per Examination" section of this report.

Other Expenses

\$12,153,060

The prior examination noted that the balance for this liability included numerous general ledger accounts that should have been classified elsewhere. The majority related to Commissions Payables that at the time should have been reported as an offset to Premiums and Agents' Balances in Course of Collection. Effective January 1, 2001, Commissions Payable are no longer reported as an offset to Premiums and Agents' Balances in Course of Collection, but are accounted for as a separate liability. There were also numerous items such as FICA tax (employer's portion), state income taxes, and state unemployment taxes, that should have been reported in Taxes, Licenses and Fees.

The current examination noted that the balance for this liability continued to include general ledger accounts that should have been classified elsewhere. It is again recommended that in future annual statements, the company classify accrued commissions, taxes, and other items in compliance with the NAIC Annual Statement Instructions—Property and Casualty.

In addition, a misallocation of commissions payable expenses between HIC and NNCC was noted. The problem occurs when an agent is due commissions on policies for both companies. The company's system is designed to issue one check for the total amount due the agent. At year-end company personnel had not properly allocated amounts between the parties. Due to the changes in reporting noted above and the lack of any impact on surplus as a result of the pooling agreement, the examination proposed no reclassifications.

Unearned Premium

\$42,735,566

The liability above includes a net reclassification of \$8,624,172 made by the examination. Highlands Insurance Company (HIC) and NNCC entered into a pooling agreement effective January 1, 2000 as described in the "Reinsurance" section of this report. HIC retains 70% and retrocedes 30% back to NNCC, after cessions to unaffiliated reinsurers. The company had problems producing an unearned premium report that could be reconciled back to the annual

statement. Difficulty providing information that reconciled to the annual statement was a common problem as noted in other sections of the report and complicated examination efforts to identify and follow audit trails. The examination utilized alternative methods to ascertain the reasonableness of the reported unearned premium reserve. This included recalculating, on a sample basis, policies that were included in the unearned premium reserve. However, the company's inability to produce complete reconciled data is in violation of s. Ins. 6.80(4), Wis. Adm. Code, that requires "Records of insurance company operations and other financial records reasonably related to insurance operations for the preceding 3 years shall be maintained and be available to the commissioner". It is recommended that the company maintain documentation to support annual statement balances in accordance with s. Ins. 6.80 (4), Wis. Adm. Code in order to provide a clear audit trail. The examination also revealed that NNCC and HIC had reported numerous errors associated with the group's interpretation of its new pooling agreement and the communication of this interpretation to responsible parties within the group. These errors related entirely to cessions and assumptions made between HIC and NNCC.

The following table demonstrates the net result of the errors and are shown net of pooling (in thousands):

	NNCC Reported	HIC Reported	NNCC Revised	HIC Revised	NNCC Diff.	HIC Diff.
Net Written Premium	\$(126,207)	\$(267,722)	\$(117,583)	\$(276,347)	\$(8,624)	\$8,624
Chg in Retro Resv (1)	0	4,731	0	4,731	0	0
Chg in Accrued Prem (1)	0	(539)	0	(539)	0	0
Net Chg in Unearned Premium Reserve	<u>27,471</u>	<u>35,351</u>	<u>18,847</u>	<u>43,975</u>	<u>8,624</u>	<u>(8,624)</u>
Net Earned Premium	(98,736)	(228,180)	(98,736)	(228,180)	0	0

(1) The change in Retrospective reserves and the Accrued premiums above are related to policy years prior to 2000 and were not subject to the pool.

The following are examples of some of the misallocation errors that contributed to the net reclassification made by the examination:

- A quota share agreement effective December 31, 1999 ceded \$60 million in unearned premium from NNCC to HIC. Both companies 1999 Annual Statements properly reported this cession. However, both companies inadvertently reported the same cession in its 2000 Annual Statements.

- Miscommunication between company personnel resulted in the company pooling accounts on both an earned and written basis. This resulted in numerous reclassifications the net of which is shown in the schedule above and was partially offset by the quota share agreement described in the preceding paragraph..

As noted in the table above NNCC's unearned premium would decrease by \$8,624,172, and its reported "Payable to Parent" would increase by an equal amount. There is no net effect to surplus as a result of these reclassifications. In addition, the net result of these errors would decrease NNCC's net premium written by \$8,624,172 and would increase HIC's net premium written by an equal amount.

Provision for Reinsurance

\$987,474

The liability reported above includes an increase of \$32,094 made by the examination. According to the NAIC Annual Statement Instructions—Property and Casualty, for each reinsurer from which recoverable balances were overdue, Schedule F, Part 7, Column 1, should contain the total amount recoverable as reported in Schedule F, Part 3, Column 10. The company was improperly offsetting payable balances, which were overdue to various nonrelated reinsurers, with its overdue recoverables. As a result, the calculation of this liability at the bottom of Schedule F, Part 7, was incorrect. The previous examination also noted errors in the company's calculation of this provision. It is again recommended that in future annual statements, the company complete Schedule F, Part 7, in compliance with the NAIC Annual Statement Instructions—Property and Casualty.

VIII. CONCLUSION

In recent years, weak operating results have been generated by the group, which were primarily attributed to its high expense structure combined with adverse loss reserve development. NNCC's operating results have mirrored the group's poor results and are demonstrated by the company's reported surplus decreasing by over \$30 million during the two-year period. During 2001, NNCC and the other members of the HIG group continued to report significant adverse development and have adjusted its business plans accordingly. See the section of the report titled "Subsequent Events" for additional comments regarding future plans of the group.

Examination adjustments resulted in additional decreases to surplus of \$21,422,813. Many of these adjustments resulted from the company's poor reconciliation process, various electronic processing system problems, and high personnel turnover that the company has experienced during the exam period. These adjustments as well as reported decreases to surplus noted above decreased surplus from \$80,408,677 to \$28,426,591 as of December 31, 2000. The examination also reclassified \$23,250,926 of balance sheet accounts.

The examination resulted in 18 recommendations, 8 of which were repeated from the previous examination. While the examination acknowledged that the company had made progress towards complying with several of the previous recommendations, it was often not significant enough to demonstrate complete compliance. Specifically, the previous recommendations regarding the company's cash reconciliation process and its review of its general ledger system may have alleviated the necessity of several current recommendations and resulted in fewer adjustments as company personnel may have identified errors prior to the issuance of the annual statement. As noted earlier in the report, NNCC assumes 100% of the business written by four of its subsidiaries. Recommendations that were made as a result of system problems and those related to retention of records may indirectly affect the accurate financial reporting of each subsidiary.

IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 24 - Conflict of Interest Disclosures—It is recommended that the company implement a procedure for the annual completion of conflict of interest statements by the officers and directors, and that such statements be maintained for review.
2. Page 24 - Disaster Recovery Plan—It is again recommended that the company create a disaster recovery plan that addresses issues necessary for the company to continue operations in the event of a disaster.
3. Page 24 - Disaster Recovery Plan—It is further recommended that the plan be completed, within 90 days from the adoption of this report, and subsequently reviewed, tested, and updated at least annually.
4. Page 24 - Claim Files—It is again recommended that the company improve its procedures regarding the maintenance of claim files to prevent files from being lost.
5. Page 25 - Reinsurance Contracts—It is recommended that the company obtain and retain signed executed reinsurance contracts and have readily available for future inspections from this office.
6. Page 25 - Reinsurance Contracts—It is recommended that the company retain documentation of its review of the financial condition of reinsurance companies it places significant reinsurance coverage with to ensure placements are made according to company guidelines.
7. Page 26 - Reinsurance Contracts—It is again recommended that the company review the systems and procedures used for recording reinsurance recoverables and recoveries, and develop procedures that will enable the company to provide detailed documentation that supports that annual statement balance.
8. Page 26 - Reinsurance Contracts—It is recommended that in future annual statements, the company complete Schedule F, in compliance with the NAIC Annual Statement Instructions – Property and Casualty.
9. Page 27 - Transition of Ownership—It is again recommended that the company, within 60 days' from the adoption of this report, thoroughly review the general ledger system, document the purpose of each account, ascertain if the account is being used as intended, and submit documentation of its completion with this office.
10. Page 28 - Cash—It is again recommended that the company reconcile all bank accounts on a monthly basis and take the necessary steps to clear reconciling items so they are not present on subsequent reconciliations.
11. Page 29 - Cash—It is again recommended that in future annual statements, the company exclude from the cash balance suspense items and other items that do not meet the definition of cash. Such items should be classified in the appropriate annual statement line.
12. Page 30 - Real Estate—It is recommended that the company properly depreciate the cost of property, other than land, over its estimated useful life, in accordance to the NAIC Accounting Practices and Procedures Manual – Property and Casualty.

13. Page 31 - Ceded Reinsurance Commissions Receivable—It is recommended that in the future, the company report ceded reinsurance commissions receivable as an offset to ceded reinsurance commissions payable, in compliance with the NAIC Annual Statement Instructions – Property and Casualty.
14. Page 32 - Unpaid Losses—It is recommended that the company improve controls associated with implementation of new data systems to ensure systems work as intended.
15. Page 32 - Unpaid Losses—It is recommended that in future annual statements, the company complete Schedule P in compliance with the NAIC Annual Statement Instructions – Property and Casualty.
16. Page 34 - Other Expenses—It is again recommended that in future annual statements, the company classify accrued commissions, taxes, and other items in compliance with the NAIC Annual Statement Instructions—Property and Casualty.
17. Page 35 - Unearned Premium—It is recommended that the company maintain documentation to support annual statement balances in accordance with s. Ins. 6.80 (4), Wis. Adm. Code in order to provide a clear audit trail.
18. Page 36 - Provision for Reinsurance—It is again recommended that in future annual statements, the company complete Schedule F, Part 7, in compliance with the NAIC Annual Statement Instructions—Property and Casualty.

X. ACKNOWLEDGMENT

The courtesy and cooperation extended during the course of the examination by the officers and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Name	Title
Cruz Flores	Data Processing Audit Specialist
Jerry C. DeArmond	Policy and Claim Reserve Specialist
Kerri Miller	Insurance Financial Examiner
Christine Shan	Insurance Financial Examiner
Sonja Dedrick	Insurance Financial Examiner

Respectfully submitted,

Tim Vande Hey
Examiner-in-Charge
Insurance Financial Examiner

XI. APPENDIX—SUBSEQUENT EVENTS

December 7, 2001, in response to continued poor operational results and further deterioration of surplus, the Highlands Insurance Group, Inc., the ultimate parent of NNCC, announced that the Board approved a plan pursuant to which the Company will cease, as soon as practical and as permitted by applicable insurance law, issuing any new or renewal insurance policies. Pursuant to the plan, the Company is considering selling books of business or transferring renewal rights to third parties. The Company also hired investment advisors during 2001 that continue to search for strategic alternatives and plans to continue reducing staffing levels and expenses as appropriate. In addition, Highlands group named Stephen Kibblehouse its sole Chief Executive Officer and Albert Marino was named Chief Financial Officer and Treasurer.

December 11, 2001, the New York Stock Exchange suspended trading in the common stock of Highlands Group.